

Introduction

Conference on Limiting Fannie and Freddie's Portfolios

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A little over two months ago, many of you were here for a conference on the receivership issue—why it was important for Fannie and Freddie's regulator to have receivership powers, and why, ultimately, it would make no difference to how they are treated in the capital markets. That was then; this is now. A lot has happened in two months, all of it good.

Today, receivership is no longer an issue, Fannie and Freddie having discovered that the rating agencies would continue to rate them triple-A, even when they were subject to receivership. One thing we have all learned during this ride is that the only thing important to the rating agencies is the fact that Fannie and Freddie are government chartered and perceived to be performing a government mission. All the talk about financial strength and good management was meaningless masquerading. How else to explain triple-A ratings for two companies that can't even publish financial statements?

The big issue now—in fact if you believe the testimony of the leaders of Fannie and Freddie, the *only* issue—is whether their portfolios of retained mortgages and MBS should be limited in some way. In fact, the issue may have advanced to the point where it is not *whether* their portfolios should be limited, but exactly how. An issue that was once “unthinkable”—that was left out of the Hagel-Sununu-Dole bill because it was so far outside the conventional consensus at the time—is now at center court.

Those who are most concerned about the risks these portfolios create are arguing that there should be a cap at some relatively low level, or that the regulator should be instructed with statutory or report language to reduce their portfolios over time to some unspecified, but low, level.

Fed Chairman Alan Greenspan has proposed a legislated cap of \$100-\$200 billion. This may be necessary, as Mr. Greenspan well knows, because the political power of Fannie and Freddie may prevent the regulator from acting without a strong mandate from Congress. Treasury Secretary Snow suggested in testimony that Congress should require the reduction to an unspecified level that provides the necessary liquidity for their securitization functions. This would be a fairly low level and reflects another sensible approach. The Baker bill, on the other hand, says only that the regulator should have the authority to require the disposition or acquisition of assets if this is consistent with safe and sound operation of Fannie or Freddie. This is a weak and almost useless

standard, because it leaves the regulator exposed to the political attacks that will accompany any effort to limit portfolio size.

While they argue that their portfolios should not be limited at all, Fannie and Freddie seem to concede that if any authority to place limits on their portfolios should be adopted it should only be imposed when they have become critically undercapitalized or have been found to be operating in an unsafe or unsound manner.

Although the outcome of this debate is not yet clear, what *is* clear is that this issue is still developing, and for the first time policymakers are beginning to consider its implications. In this process, everything will eventually be stripped down to its essentials, but right now we are still at the intermediate, posturing stage.

In that stage, Fannie and Freddie are still arguing that retaining portfolios of mortgages and mortgage-backed securities is necessary for their “mission.” In your packets, we have included lobbying material that Freddie Mac has been circulating on the Hill and using to brief lawmakers and staff. If you read it over, you can see for yourself how weak their arguments are. Political power alone may win the day, of course, but it is obvious from reading this stuff that they wouldn’t have a leg to stand on if the law-making process were a completely rational process. Also in your packets is a set of responses by the indefatigable Bert Ely, which demonstrates this point by knocking down every one of Freddie’s points quite easily and effectively.

One of the arguments in the Freddie document is that the debt needed to support the mortgage portfolios is essential to attract funding from abroad. But last week I met with a central banker from one of the major developed countries, who said that his bank was not concerned about a decline in the amount of debt issued by Fannie and Freddie. The bank had already begun switching to MBS.

The fact is that Fannie and Freddie could do everything they now do for the mortgage markets—which isn’t much to begin with—by securitizing mortgages rather than holding them in their portfolios.

As I noted, the issue is still developing, and will eventually be stripped to its essentials. What are these essentials? The first is mortgage rates. The one issue that really counts on the Hill, of course, is mortgage rates. No lawmaker wants to be charged with having done anything that increases rates by even a smidgen.

What effect will limiting Fannie and Freddie’s portfolios have on mortgage rates? Alan Greenspan and the economists at the Fed have concluded that the accumulation of mortgage portfolios has no effect on interest rates. Today’s conference is about this issue. I believe Fannie and Freddie will eventually lose this argument on the merits. Limiting their portfolios will eventually be seen to have no effect on mortgage rates.

The second of the essentials is profitability. Fannie and Freddie make most of their profits—by a wide margin—by taking the interest rate risk associated with their retained portfolios. That’s why they are fighting so hard to keep these portfolios. This gives us a clue as to what their fallback argument will be if in fact they lose the debate

about whether their portfolios contribute to lowering mortgage rates, and if their raw political muscle can no longer save the day.

That argument, I predict, will be that if their portfolios are limited they will become so unprofitable that they will be required to privatize. If you read carefully the testimony of Richard Syron last week, you will see a hint of this position. To support this threat, Fannie and Freddie will note that they are in fact private companies, with fiduciary duties to their shareholders. Their “mission,” to put people in homes or to reduce mortgage rates, will be conveniently forgotten, as it will be by their supporters in Congress.

The shock value of this position will be considerable on the Hill, and may succeed in stopping the momentum of any bill that includes significant limitations on Fannie and Freddie’s portfolios.

But let’s hope Congress considers this argument on its merits. Is there any reason why any company—least of all a government subsidized company—should be guaranteed profitability? We’ve already tried this idea and rejected it long ago. At one time, the Comptroller of the Currency would limit the number of bank charters granted in a particular area, in order to assure that regulated banks were not weakened by excessive competition. And the Federal Home Loan Bank Board was supposed to promote the thrift industry as well as regulate it. It became obvious, however, that insulating banks from competition only weakened them and reduced the quality of their services, and in the case of the thrift industry promotional activity by their regulator—and the consequent forbearance—resulted in the eventual collapse of the whole industry. The Federal Home Loan Bank Board was abolished, and the Office of Thrift Supervision established in its place, without any authority to promote the S&L business.

Yet there are certainly some who will endorse the idea that the taxpayers should not only take the risk associated with Fannie and Freddie’s accumulation of portfolios, but homebuyers should pay the hidden costs associated with assuring that they remain profitable. And not all of them are in Congress.

Ron Rosenfeld, the new chairman of the Federal Housing Finance Board, in testimony last week, is reported to have said that Congress should be careful in limiting Fannie and Freddie’s portfolios, because that might cause a substantial decline in their profitability. From time to time, one hears that Mr. Rosenfeld might be considered as a successor to Armando Falcon as the regulator of Fannie and Freddie. If Mr. Rosenfeld actually said this, it is grounds for immediate disqualification. No regulator should consider it part of his job to assure the continued profitability of the companies he regulates, and least of all should Fannie and Freddie receive this dispensation. To maintain their profitability through allowing them to accumulate portfolios of mortgages and MBS, would be a particular disservice to the public, because it would saddle the taxpayers with risk while doing nothing to help homebuyers.

One hopes that when Fannie and Freddie start to argue that if their portfolios are limited they will have to privatize, lawmakers will recognize this as an effort to

intimidate, and not a policy argument. If an activity is so risky that it must be limited or prohibited, it cannot be good policy to let the activity continue so that the regulated company can profit from it. And if a regulated company will not perform its government “mission” unless it can also make high profits while doing so, then it’s not dedicated to its mission at all—it’s just exploiting its connection to the government, and the resulting subsidy, to benefit its stockholders and management. And, finally, if this means that Fannie and Freddie will have to privatize in order to serve the interests of their stockholders, then they shouldn’t be government-sponsored enterprises at all, and their privatization should be encouraged.